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DOW THEORY LETTERS INC.

"The Market as Interpreted under the Dow Theory"

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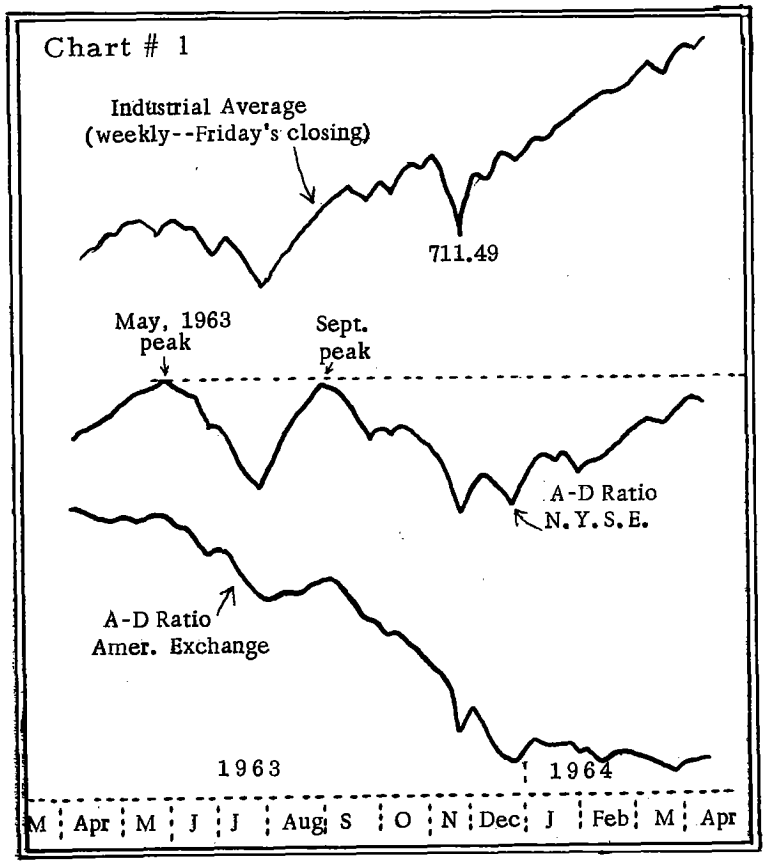
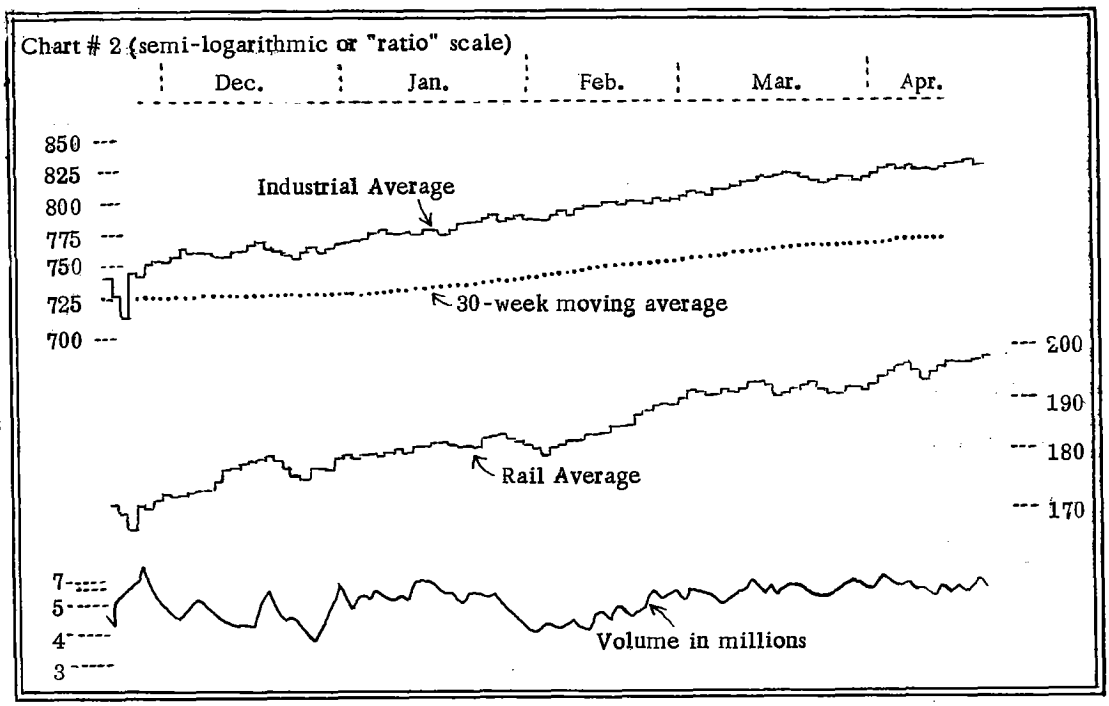
THE MARKET: Over the past week Industrials and Rails have risen to joint new all-time highs. Under Dow Theory, when new highs are recorded by the Average, the significance of all previous marks is erased. As far as downside "check points" or "support levels" are concerned, it is now up to the Averages to establish new ones; and the ability of the Averages to hold above any new decline points will constitute a future "test" of market strength or weakness.

In the last Letter I discussed the drop in margin accounts (debit balances) from the record peak established in November, 1963. This was labeled the probable beginning of the professional exit from the market. At the same time I noted that the credit balances or cash accounts had been moving sideways during the past year, and this was indicative of the indecisiveness of the cash customer (i. e., the public). The latest figures for March show more of the same. Margin accounts dropped $18 million in March to touch a six month low, but credit balances rose $31 million, and this (after a $63 million drop in February) suggests that the public is still unable to make up its mind.



Undoubtedly the public is still suffering from the shock of the 1962 crash. We can "see" the public's hesitancy in the sinking A-D ratio on the American Exchange (Chart 1), in the erratic credit balance figures (Letter 250), and in the current indecisive odd-lot balances (one day the public buys slightly; the next day they sell, but there does not seem to be any fixed pattern). Is the public now about "to take over" as they did in 1959 and 1961? No one can be sure, but we see a few scattered hints in the affirmative. For instance, a few weeks ago volume on the Amex suddenly spurted to 10 million shares, highest weekly upside total since late 1961. Late last week (as news of a major ore strike hit Canada) volume on the Toronto Exchange exploded to the 16-30 million share per day class. The bait is dangling, and the professionals (as seen by the declining margin balances) are slowly exiting from the scene. It is up to the public to keep the party going.



TIMING: In the last Letter I noted that the advance-decline ratio was nearing its May, 1963

peak (Chart 1). As the all-important 1963 high is approached, it will be particularly interesting to see what occurs. From the long-term (overall) standpoint, it is important to remember that the Industrial Average has now advanced for eleven months beyond the May, 1963 peak on the A-D ratio, and this constitutes a longevity record for a period of breadth-price divergence. We should also remember that the daily new highs "topped out" at 184 on April 15, 1963 (eleven months ago); the short interest ratio topped in October, 1962 (eighteen months ago); General Motors struck its high on October 29 (almost six months ago). Normally, any one of these events should be cause for concern.

PROS AND CONS: "Some services are always positive," wrote Robert Rhea. "In the long run they may be right half the time. They ballyhoo their correct guesses and hush-hush the wrong ones." The way ahead in the market is seldom crystal clear (although it is quite clear on rare occasions). At the moment there is plenty of fog on the crystal ball, and for this reason I have spent a good deal of time going over the most convincing current bull and bear arguments. Subscribers might study the following arguments carefully and then draw their own conclusions. My conclusions appear at the end of this section.

Bullish arguments: (1) The market has yet to "blow its top" on this move. The public (as shown by the odd-lot and credit balance figures) have not yet come in as they did in 1959 and 1961. Many competent observers believe that this rise will end like most others — with a public buying spree. If this is the case, the rise has further to go.

(2) The Averages are continuing to plot a bullish pattern. As long as this is the case, it would be well to abide by the axiom. "The prevailing trend continues until proved otherwise". Furthermore, the Industrials continue to hold above their 30-week moving average and the number of individual stocks holding above their 30-week moving averages is still well above 50%. Why get bearish until these indicators signal trouble?

(3) The total short interest on the N.Y.S.E. has not dropped substantially since its all-time high of just over 7 million shares. The current historically high short interest implies that too many people are still bearish. Barron's Confidence Index has just climbed to a new high of 97.4. This too suggests another upward push during the summer. Volume indications are still reasonably bullish in that transactions continue heavy on the upside -- but days of decline do not succeed in bringing out heavy volume.

(4) This is an election year, and President Johnson has shown that he is an expert at getting things done. All evidence suggests that the President will do everything short of giving away greenbacks in order to keep the economy rolling until election day.

(5) The market is surprisingly resistant to bad news and shock. Neither the Rail altercation nor the recent steel company indictment succeeded in shaking Wall Street. If the market were ready to collapse, it would be doing so now.

Bearish arguments: (1) Bullishness is now rampant. Moreover, almost every market service appears to be preparing its readers for a final "blow-off" (and then perhaps trouble towards the end of 1964 or during 1965). Almost no one believes the market to be at or near a major top now. In September, 1937, Robert Rhea wrote: "Danger signs are easy to read when 'the market can't go down' and when all of us soothsayers are placing the next collapse in stock prices months or years ahead."

(2) Stocks are now plainly overvalued. This is documented in the "Values" section of this Letter.

(3) The whole bull structure has overextended itself in terms of time. The first phase of the bull market lasted from 1949 to 1953 (four years). The second phase lasted from 1954 to 1957 (three years). The third phase of the bull market seems to have expanded into an unprecedented three-part affair which has now lasted five years (part one — 1957-60, part two —1960-61, part three —1962 to the present). Historically, however, the third phase of a bull market is the shortest. Yet because of massive Government infusions of credit, the speculative (but "tired") third phase continues. From the standpoint of time, the last phase of the great post-war bull market has been greatly extended. The bull market's demise is dangerously overdue.

(4) A glance at any long-term chart books will show that almost every stock on every exchange has had its speculative fling. There is hardly an issue which has not boomed at some period between 1956 and 1964. During the 1949-56 period, almost all stocks rose together. This was the period of impressive breadth. Since then, the upside action has been increasingly sporadic. This is a symptom of "tired market blood". It is probable that the next massive, all-inclusive movement in breadth will be down. Since 1959 the major declines in the advance-decline ratio have been much more impressive than the major advances.

CONCLUSION: As I see it, the bearish arguments may be longer term but they are very convincing; the bullish arguments are also impressive, but they tend to pertain to the short or intermediate term. It is obvious that a further extention of the market advance would render the entire market more speculative and more overvalued than ever. Therefore, the situation resolves itself into one of tactics.

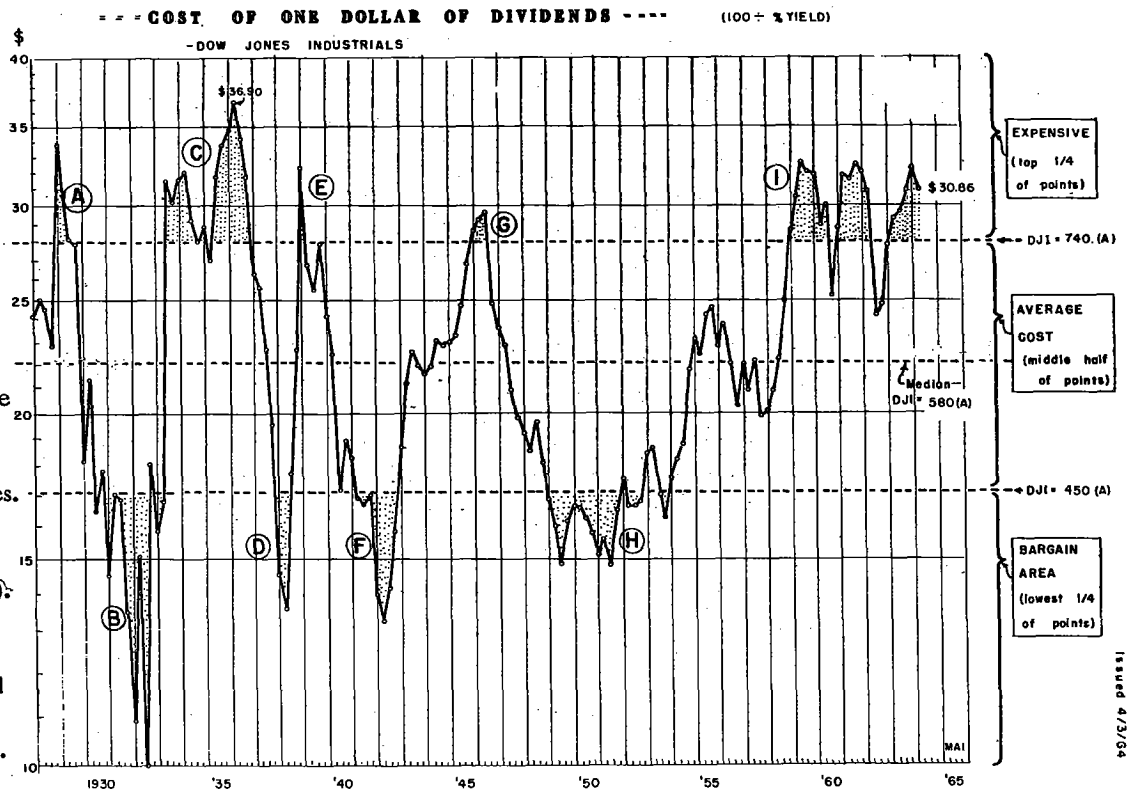
As far as long-term investors are concerned, I continue to see this area as part of a major "selling opportunity". It is obvious that one is playing for the most dangerous and frothy stage of the advance from here. Robert Rhea, a brilliant analyst and trader, made a habit of avoiding the late stages of an advance. Thus he wrote of 1928-29: "When the crash came in September-October, 1929, it was with considerable satisfaction that I realized that I had not been sucked into the whirlpool of frantic trading during the third phase of the great bull market." Again on January 25, 1937 (two months before the 1937 top) Rhea stated: "If a further rally is now to develop, and I do not profit thereby (Rhea had sold out) I shall not regret it.... the market is always available, and I have never liked playing what I believe to be the final phase of an extended uncorrected rally."

It is my opinion that the current situation is well covered by either of the above quotes from Rhea. Undoubtedly, many traders garnered large profits during the late stages of '29 and '37, but the opportunities for profits on the upside were far outweighed by the dangers on the downside. Readers should keep this well in mind when following the stock selections which appear at end of each of these Letters.

VALUES: With the current wide-spread acceptance of the technical approach to the market, one is apt to read less and less about stocks as fundamental "values". Yet if one studies the work of the pioneers who actually developed the technical approach, Dow, Hamilton, Rhea, Schabacker, it becomes readily apparent that all of these gentlemen laid great stress on the concept of values ("Over any reasonable length of time," wrote Dow, "the trend of stocks is towards values").

Perhaps without being aware of it, investors have witnessed a continuing "test" of values during the past five years. The accompanying chart was drawn by Mr. A. Merrill, Merrill Analysis, Box 228, Chappaqua, New York). Here we see the cost of one dollar in dividends on the D-J Industrial Average, which is actually just another way of presenting the yield cycle (figures on chart are computed by dividing the yield percentage on the DJI into 100).

The chart is divided into four horizontal quarters. The upper quarter is labeled the "expensive" section, and at the present time this would be anything over 740 in the Industrial Average. The bottom quarter is called "bargain" territory, and in today's market this would be represented by a figure of 450 or below on the Industrial Average. The middle half of the chart is average or "fair" valuation — in other words, any figure between 450 and 740.



Note that since the 1920's there have been five "expensive" periods or areas of overvaluation. These are marked A, C, E and G on the chart. After each period of overvaluation, the market turned down and the stocks entered a period of under-valuation — the so-called bargain area (B, D, F, H on chart).

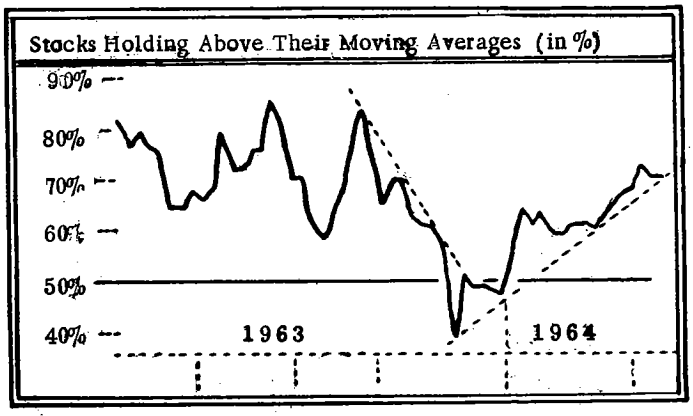
The last "bargain basement" zone occurred during 1949-50, and this was followed by a long series of advances in the Averages. By late 1958 the Industrial Average had again entered the zone of overvaluation (I on chart). The area at I is unlike anything seen before. The first peak in overvaluation came in 1959, and this was followed by an extended decline in the Industrial Average. As seen on the chart, the cost of a dollar of dividends dropped into the upper part of the "average cost" area (1960).

Perhaps due to Government "pump priming" and "cheap money" policies, a second major advance in the Industrial Average got underway. As seen on the graph, the cost of a dollar of dividends rose in 1961 to almost the exact level as 1959. Distribution occurred all during 1961 and early 1962, and the market crashed in the spring of '62.

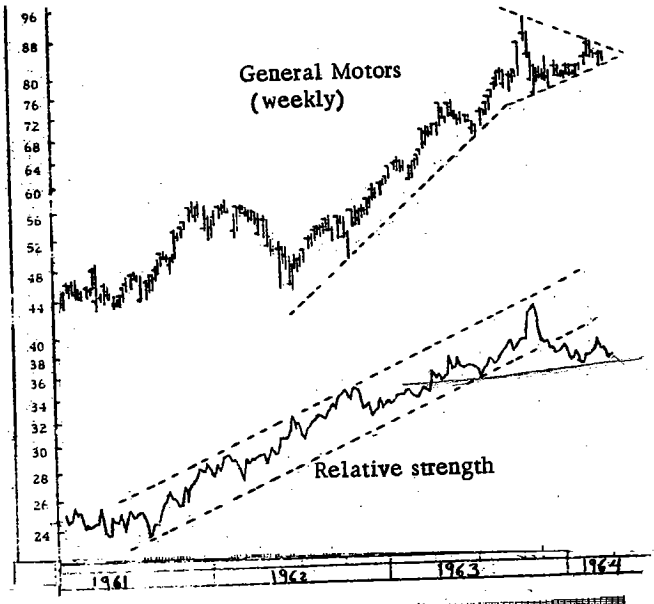
The crash took the cost of a dollar of dividends further into the average cost zone than it had gone in 1960, but instead of continuing to the bargain area, the market turned up again. This was the rise of 1962-64. At this point it would be well to note that the current rise has again succeeded in taking the graph to the level of the 1959 and 1961 peaks of overvaluation.

Based on the 38 year history of the cost of a dollar of dividends, we must conclude that the Industrial Average is now in the expensive area. Stocks have entered a zone where the risk of decline has always been considerably greater than the opportunity for important gain. This is the reason why I have insisted that all stock holdings and purchases at this time be considered nothing more than speculations in a broad area of dangerous overvaluation.

STOCKS: Of 432 stocks which are tabulated here weekly, 321 (70%) are now holding above their long-term or 30-week moving averages (no change from last week). This study is bullish as long as the percentage is above 50%. Note, however, that the line is now touching the rising trendline which started at the "assassination low". If this line is penetrated, it will suggest the beginning of what could be an important decline in the bullish percentage.

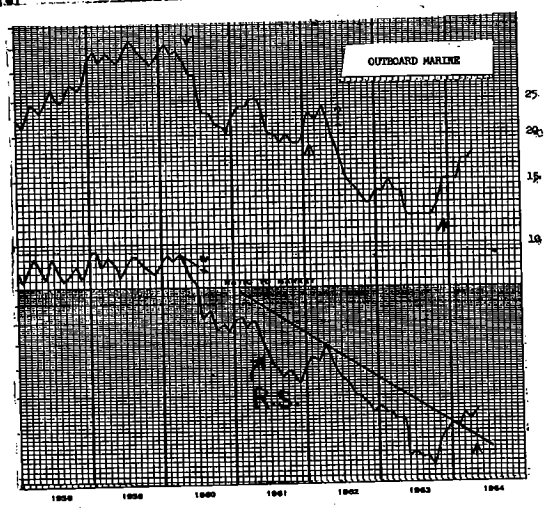


With record auto sales spurring almost every segment of the economy, the action of the nation's leading auto company becomes doubly significant. Although this is a market which has broken any number of historical precedents, it is worth remembering that no major market advance has ever progressed longer than six months beyond a peak in General Motors. GM hit its all-time high of 91 3/8 in late October. By the end of April six months will have elapsed since the October peak in GM.



The weekly chart shows that GM has traced a symmetrical triangle after breaking (sideways) through the long ascending trendline which started at the 1962 bottom. It is fascinating to note that although the 1962 crash did not interrupt the rise in GM's relative strength (R. S.) line, the R. S. line has recently been reversed — in the face of one of the most bullish barrages of auto news ever seen! This would not appear to bid well for the stock. However, the resolution of the triangle will tell the story better than anything else. A rise to 86 would penetrate the triangle topside while a decline to 79 would break the triangle on the downside. The fact that GM has moved almost to the apex or tip of the triangle is not a hopeful sign. Most forceful upside breakouts from triangles occur when the price rises out of the triangle well before reaching the apex. Once the price nears the apex, the force of any forthcoming rise seems to spend itself.

Continuing the discussion of lower priced stocks, the monthly chart of Outboard Marine is worth studying. The stock came down from its 1959 high of 39 to trace out a double bottom at 11. The monthly chart shows OM's relative strength line reversing a four-year declining trend. The smaller weekly chart shows OM moving above its 10-week moving average (solid line) which in turn is above the 30-week moving average (dotted line). Thus the disposition of these three lines is bullish, and the stock is now returning to market popularity.



Much of what can be said of OM also pertains to Giant Portland Cement. The monthly chart shows a five-year decline in R. S. in the process of reversal. The weekly chart shows price pushing sharply above the moving averages. The stock is on a 5% yield basis which makes it almost a freak (but an attractive one) in today's market.

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Chart of GM courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003. Small weekly charts of OM and GPO courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas. Monthly charts of OM and GPO courtesy of Ray * Signals, 141 Broadway, New York 6, New York.